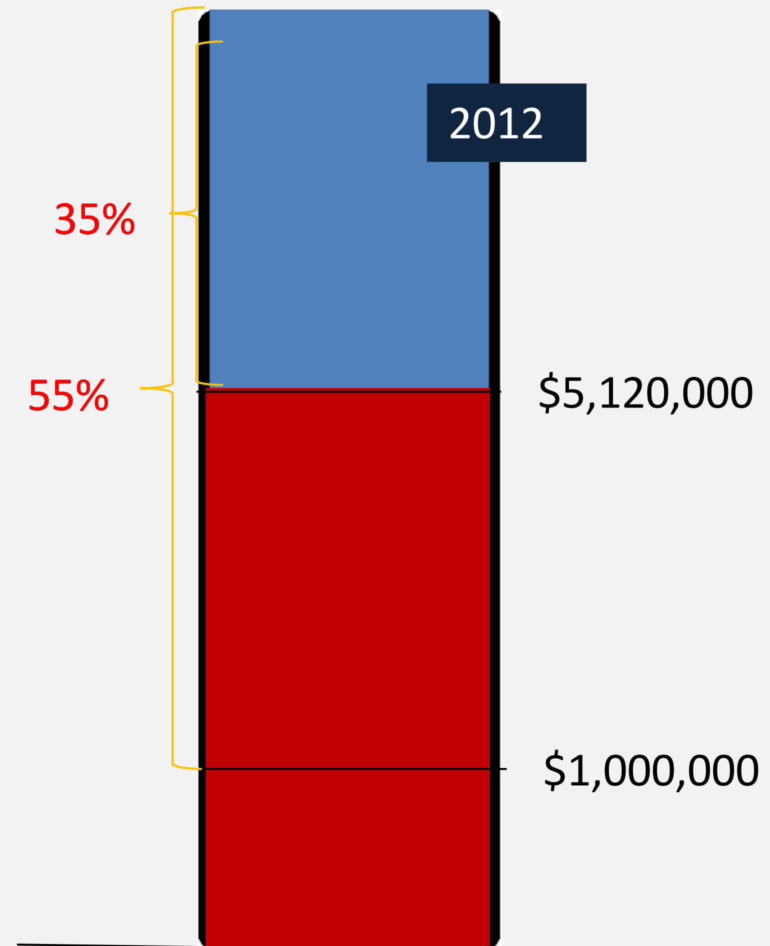
2012 – A Unique Opportunity to Make Gifts And Save Estate Tax

EDWARD L PERKINS, JD, LLM (TAX), CPA

GIBSON&PERKINS PC
Suite 204
100 W Sixth Street
Media, Pennsylvania 19063
610 565 1708
www.gibperk.com

INTRODUCTION

2012 presents a unique opportunity to reduce potential federal estate tax by making lifetime gifts. This is primarily because the current exemption from the federal gift and estate tax stands at $5.12 million through 2012 (as indexed for inflation). The federal and gift estate tax rate presently stand at 35%. However, in 2013, the exemption will be reduced to $1 million, pending further action by Congress to extend the current exemption or establish a new one. If Congress fails to act before 2013, the highest marginal rate will increase to 55 percent next year. If the federal estate tax law is not amended for 2013, and beyond, taking advantage of the additional $4.12 million gift tax exemption this year could result in a permanent estate tax savings of as much a $2,268,750 - $4,437,500, for a married couple.



The Impact of the Tax Relief Act

After a one year repeal, the Tax Relief Act of 2010 reinstated the federal estate tax for at least 2011 and 2012, and if elected by the estate of someone dying in that year, for 2010, as well. During those years, the highest marginal estate tax rate is be 35%, and the exemption amount (termed the "Basic Exclusion Amount") is increased to $5 million per individual for 2011, and has been indexed for inflation to $5,120,000, for 2012.

In 2011, the gift tax exemption was unified with the estate tax exemption. This means that a $5,120,000 Basic Exclusion Amount will also be available for gifts. Prior to 2010, an individual was entitled to a $3.5 million exemption for their estate, but only $1 million for gifts.

Because gifts in excess of that amount required payment of gift tax out of pocket, many potential donors were hesitant to make those gifts. Now, an additional $4,120,000 can be transferred gift tax free. Barring any further action by Congress, the Basic Exclusion Amount will reset at $1,000,000, after 2012.

Should You Make Gifts in 2012?

The question of whether or not to make gifts in 2012 is a difficult one to answer. The enticement of the $5,120,000 gift tax exclusion and the 35% tax rate is hard to resist. If one could predict with certainty that the Basic Exclusion Amount would revert to $1,000,000, and a 55% marginal tax rate, the question would be easier to answer.

However that is only one of several possibilities. Others include complete estate tax repeal – the Obama proposal of a $3,500,000 exclusion for estates, and a $1,000,000 exclusion for gifts, coupled with a top tax rate of 35%, or something in between. In determining whether to make gifts in 2012 – what principles apply?

What Gift Amount Should be Considered?

First – one should consider gifting assets with a value equal to the excess of the current Basic Exclusion Amount (i.e., $5,120,000) over the anticipated Basic Exclusion Amount (i.e., the level at which it resets in 2013). Unless the federal estate tax is repealed or the Basic Exclusion Amount set at $5,120,000, or higher, gifts in this range will result in a permanent estate tax savings, and incur no current payment of gift tax.

If the estate is valued at or below the anticipated Basic Exclusion Amount gift should not be considered. Assets representing that level of value should be retained. No estate tax reduction will be achieved by gifting, and those assets will receive a basis step for income tax purposes – which would be lost if a gift transfer were to be made.

Current
Basic Exclusion Amount

Less

Anticipated
Basic Exclusion Amount
=

Gift Amount*

** Double this Amount for a Married Couple – Each of a married couple can take advantage of a Basic Exclusion Amount of $5,120,000.*

What Gift Amount Should be Considered?

The question is the "What anticipated Basic Exclusion Amount you should plan for"? If one assumes that the Basic Exclusion Amount will be revert to the $1,000,000 level as presently provided in the law, gifts of up to $4,120,000, and $8,240,000 (i.e., the difference between the current Basic Exclusion Amount of $5,120,000 and $1,000,000), for a married couple should be considered. A better bet is that the Basic Exclusion Amount will be reset around $3,500,000, consistent with the Obama Administration's proposal. If that is the assumption gifts $1,620,000, (i.e., the difference between the current Basic Exclusion Amount of $5,120,000 and $3,500,000), $3,240,000 for a married couple should seriously be considered.

	$5,120,000
Less	$3,500,000
	$1,000,000
=	$1,620,000*
	$4,120,000*

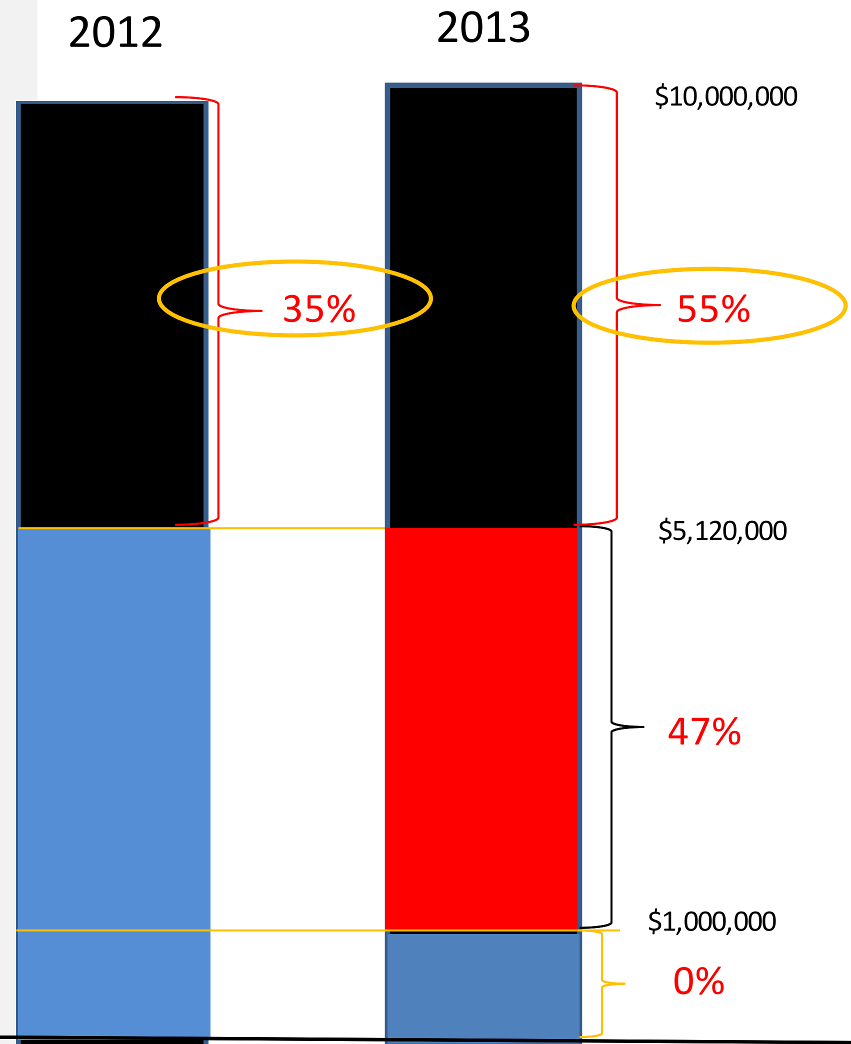
Double this Amount for a Married Couple – Each of a married couple can take advantage of a Basic Exclusion Amount of $5,120,000.

Should You Consider Gifts in Excess of that Amount?

Should you consider gifts in excess of the excess of the current Basic Exclusion Amount over the anticipated Basic Exclusion Amount?

If the value of the estate exceeds the current Basic Exclusion Amount of $5,120,000, gifts of the excess should be considered in order to take advantage of the 35% rate in effect this year. The potential estate tax savings could be the 20 percentage point difference in rates (i.e., 55% less 35%).

Prior to making gift in this range of value, *you should also consider the income tax consequences of doing so.*



Should You Consider Gifts in Excess of that Am

The question is "Is the anticipated Estate Savings greater than the Value of the Loss in Basis Step Up?"

When an individual receives an asset from a decedent's estate, the income tax basis in the asset is increased equal to the asset's fair market value as of the date of death – the so-called basis "step up". Asset which are gifted on the other hand have a basis equal to the transferor's basis.

In order to make the determination of whether the *Anticipated Estate Tax Savings* outweigh the *Value of the Loss "Step Up" in Basis* a calculation must be made. In making the calculation certain assumptions must be made.

Example: Stock in ABC, Inc has a basis in the hands of Mr. X of $1,000. Mr. X dies - the fair market value of the stock at that time is $5,000 – The basis of the ABC stock in the hands of Mr. X's heirs is "stepped up" to $5,000.

If on the other hand Mr. X had gifted the stock during his lifetime the basis in the hands of the donees would equal his basis or $1,000.

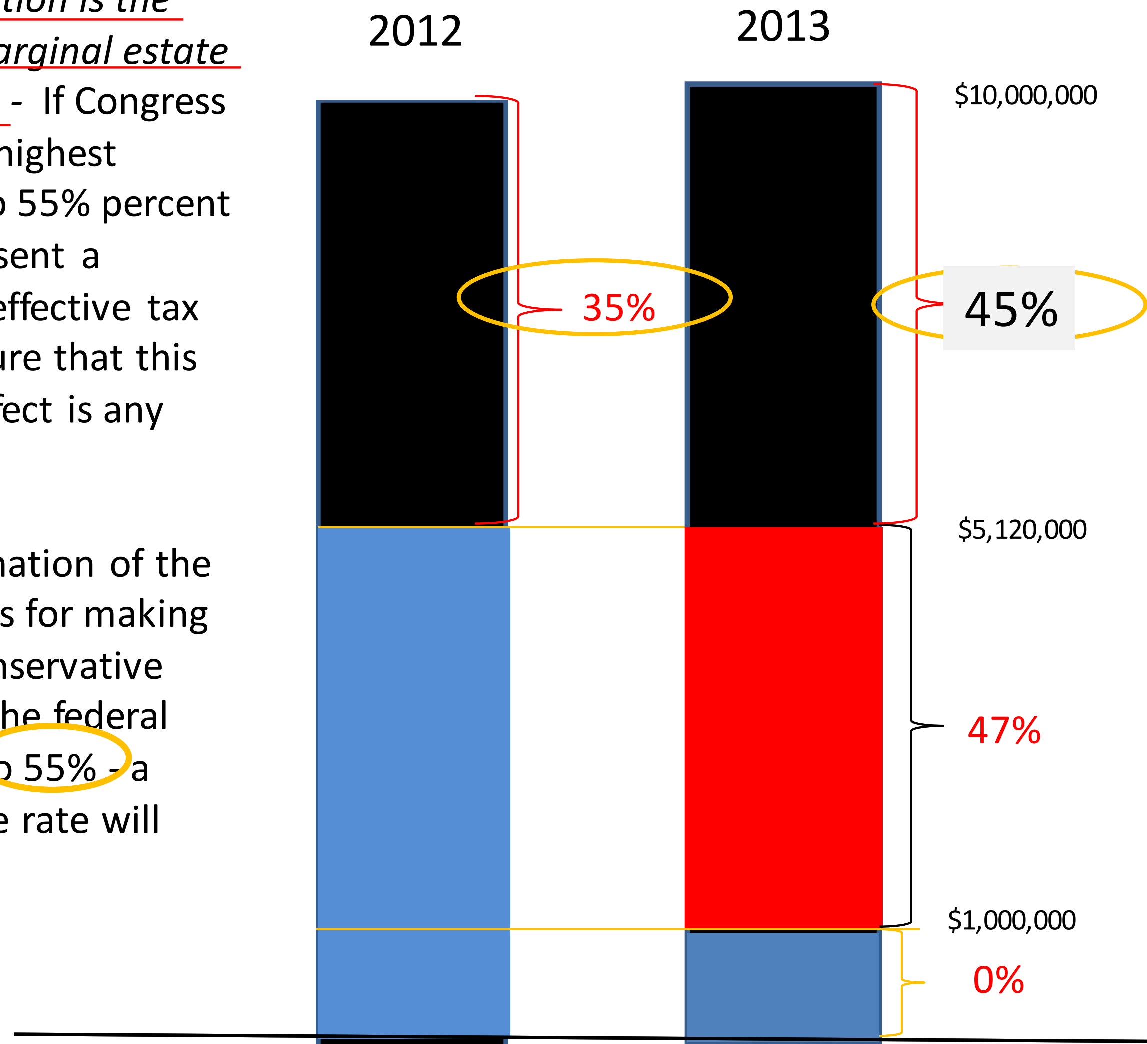
$5,000

$1,000

Should You Consider Gifts in Excess of that Amount?

One important assumption is the level at which the highest marginal estate tax rate will reset after 2012 - If Congress fails to act before 2013, the highest marginal rate will increase to 55% percent next year, and this will represent a increase of 20 points in the effective tax rate. Whether you can be sure that this increase will actually take effect is any body's guess.

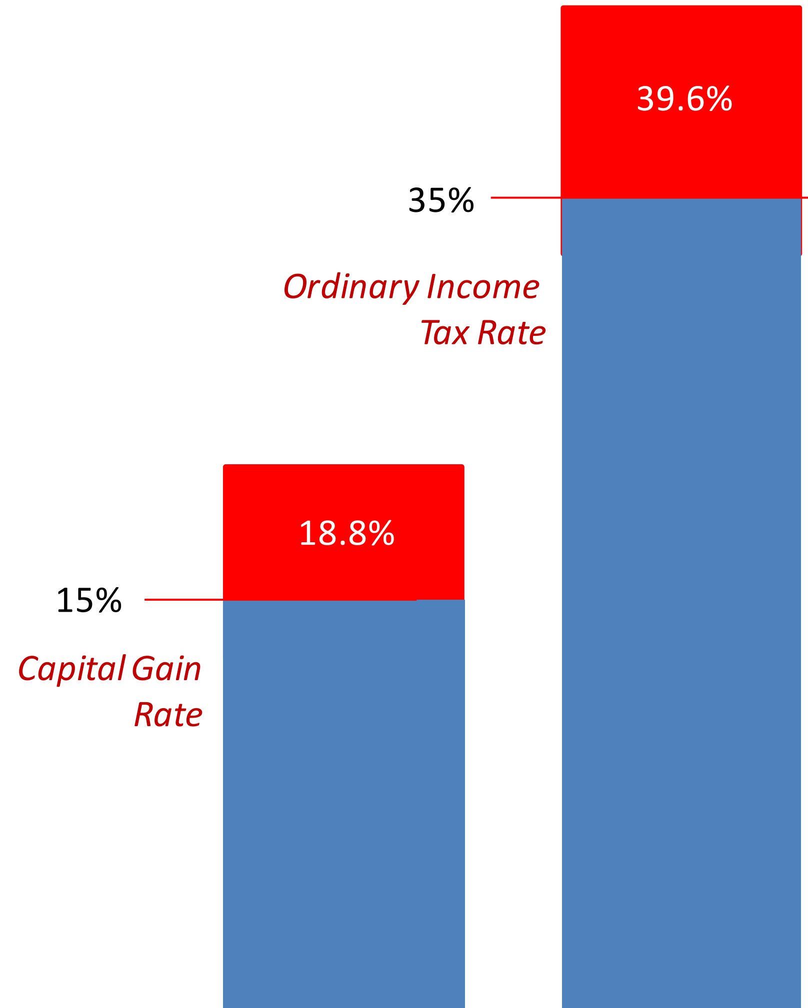
In making the determination of the anticipated estate tax savings for making gifts in this range a more conservative approach is to assume that the federal estate tax rate will not rise to 55% - a better assumption is that the rate will reset at 45%.



Should You Consider Gifts in Excess of that Amount?

The second important assumption is the level at which the highest marginal income tax rates will reset after 2012 - Because of the scheduled end to the Bush Tax Cut in 2013 – that marginal income tax rate also comes into question In determining the value of the loss of basis step up a long term capital gain rate of at least 18.8% should be assumed. If ordinary income property is involved then assuming a 39.6% tax rate might be appropriate.

You should also consider that there is tax advantage in actually paying gift tax. This is occurs because the gift tax is removed from the taxable estate as long as the gift is not made within three years of death.



Should You Consider Gifts in Excess of that Amount?

In making this determination the following formulas should be used:

Anticipated
Estate Tax Savings
=
Fair Market Value of the Asset
x
(Estate Tax Rate at Death – 35%)

Value of Loss in Step Up in Basis
=
[Fair Market Value of the Asset - Adjusted Income Tax Basis]
x
Income Tax Rate at Death

Here is example to which will illustrate how this calculation should be made.

Example: Asset has Fair Market Value of $1,000,000 Adjusted Basis $200,000 – Income Tax Rate at Death 18.8% – Tax Rate at Death 45%

Should You Consider Gifts in Excess of that Amount?

In making this determination the following formulas should be used:

Anticipated
Estate Tax Savings
=
Fair Market Value of the Asset
x
(Estate Tax Rate at Death – 35%)

Value of Loss in Step Up in Basis
=
[Fair Market Value of the Asset - Adjusted Income Tax Basis]
x
Income Tax Rate at Death

Here is example to which will illustrate how this calculation should be made.

Example: Asset has Fair Market Value of $1,000,000 Adjusted Basis $200,000 – Income Tax Rate at Death 18.8% – Tax Rate at Death 45%

Anticipated Estate Tax Savings
=
FMV of the Asset or $1,000,000
x
(Tax Rate at Death 45% – 35%) or 10%
or
$100,000

Value of Loss in Step Up in Basis
=
FMV of the Asset or $1,000,000
- Adjusted Basis - $200,000
x
Income Tax Rate at Death – 18.8%
or
$150,400

Should You Consider Gifts in Excess of that Amount?

In making this determination the following formulas should be used:

Anticipated
Estate Tax Savings
=
Fair Market Value of the Asset

In this case the Anticipated Estate Tax Savings of $100,000, would be less valuable than the Value of the Loss in Step Up In Basis of $150,400 – and gifts would probably not make sense.

[Fai

However if we changed the facts and assumed an Adjusted Basis of $800,000, instead of $200,000 – the Value of the Loss of Basis Step Up would be reduced to $37,600, and gifts in 2012 would produce a better tax result.

Here

calculation should be made.

Example: Asset has Fair Market Value of $1,000,000 Adjusted Basis $200,000 – Income Tax Rate at Death 18.8% – Tax Rate at Death 45%

Anticipated Estate Tax Savings
=
FMV of the Asset or $1,000,000
x
(Tax Rate at Death 45% – 35%) or 10%
or
$100,000

Value of Loss in Step Up in Basis
=
FMV of the Asset or $1,000,000
- Adjusted Basis - $200,000
x
Income Tax Rate at Death – 18.8%
or
$150,400

Techniques for the Reluctant Donor

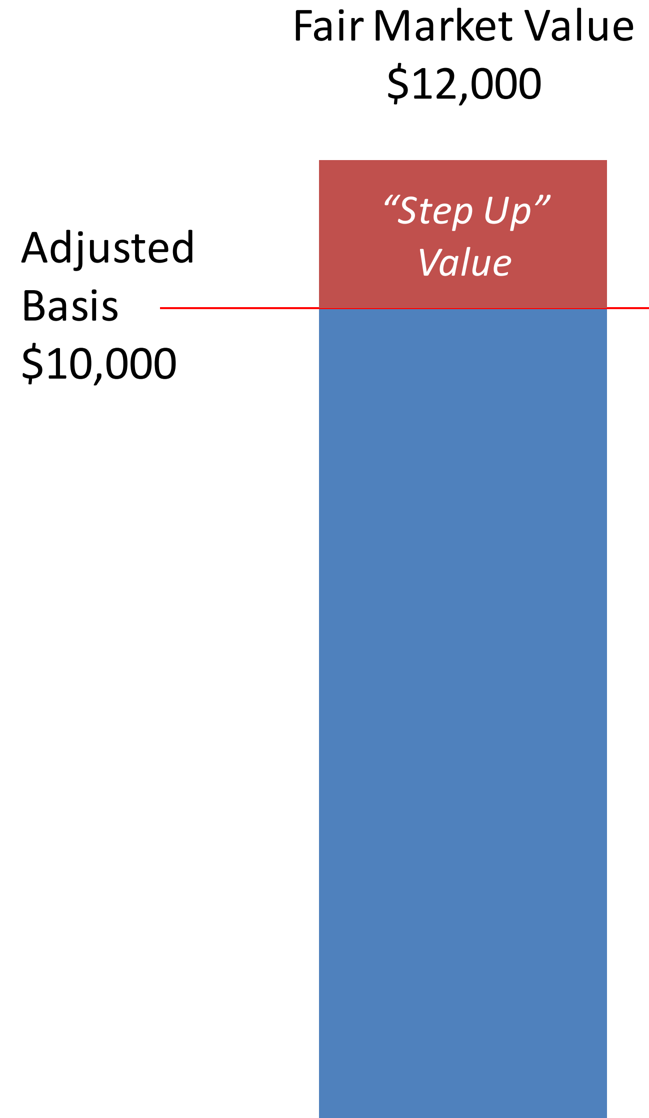
If you are not still not convinced that gifts in 2012 are good idea consider the following techniques -

- > *Gift High Basis Assets*
- > *The Delaware Discretionary Trust*
- > *Spousal Trusts*

Gift High Basis Assets

Gifting assets with a low adjusted income tax basis relative to fair market value is generally not as tax advantageous in the context of gifting strategy since having a low income tax basis will increase the value of the loss of basis step up. If the basis of the asset is relatively high and the value of the basis step up is eliminated or relatively low – it may be worth it to risk losing the step up in order to obtain potentially greater estate tax savings. Gifts of cash are ideal – the basis and the fair market value are always equal.

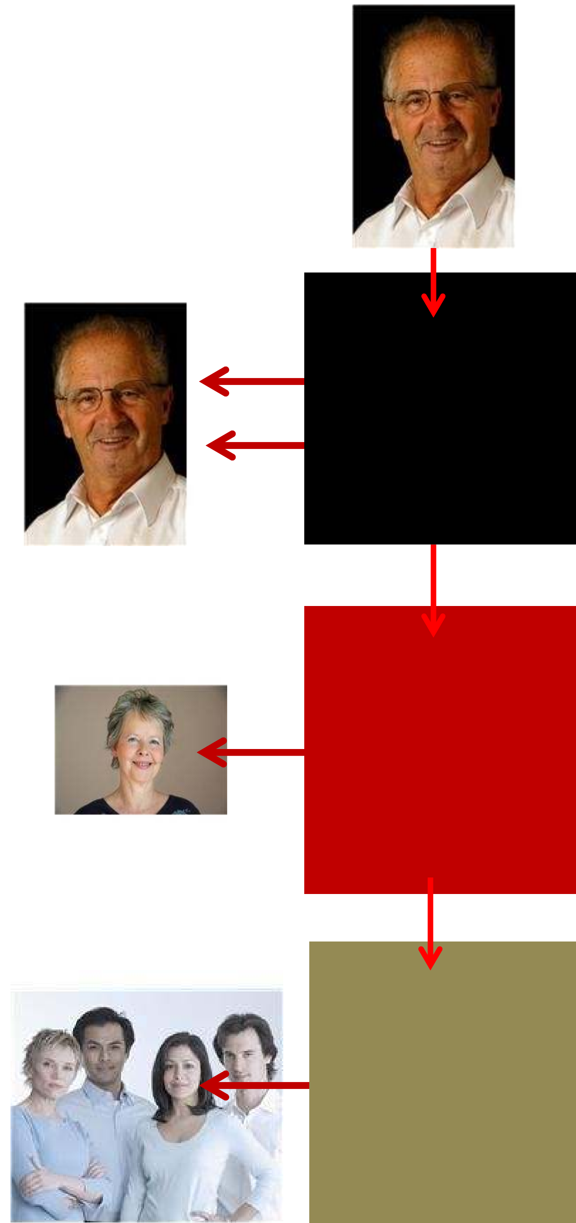
One must also factor in that the estate tax is based on entire fair market value of property on the date of death, while the value of basis step up is based only on the difference between the fair market value at the date of death and the adjusted basis of the property in the hands of the decedent.



The Discretionary Trust

In states, like Delaware, that afford creditor protection to self settled trusts, property can as a completed gift be removed from the transferor's estate by transfers to such trusts. This is true even if the you as the transferor is entitled to receive distributions from the trust made in the discretion of a third party . As a result you can actually transfer to trust and retain the right to receive distributions of income and principal from the trust and still have the trust value removed from your taxable estate.

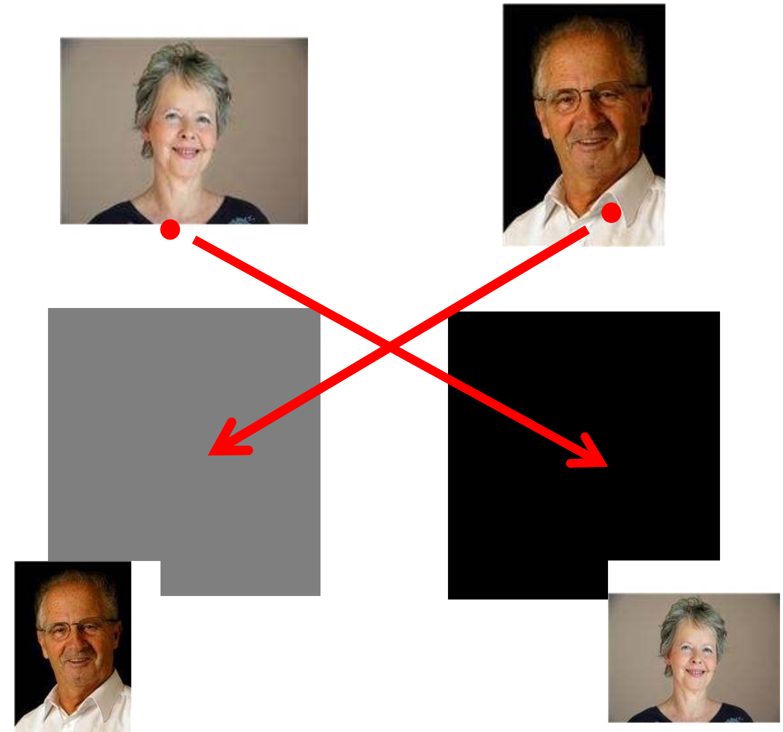
In states where creditors of the transferor can access property transferred to a self-settled trust, the IRS has taken the position that the gift is incomplete.



Reciprocal Spousal Trusts

Spouses can also transfer property to trusts for the benefit of each other. If the trust qualifies as what is known as "QTIP" trust and an election is made not qualify the transfer for the federal estate tax marital deduction, the transfer will be considered a completed gift and the assets removed from the transferor's taxable estate.

Care should be taken to avoid the application of the reciprocal trust doctrine by varying the terms of each trust, and perhaps the amount transferred as well.



Call Us to discuss whether Gifting in 2012 is Appropriate for You?

Ted Perkins
610-565-1708 Ext 4

Estate planning is highly personal, and the material contained in this presentation should not be considered a substitute for individual legal advice.